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**Principles of Financial Planning:**

**Transfer Taxation**

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## ABOUT GREENE CONSULTING ASSOCIATES, LLC

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## Introduction

Most people have some level of familiarity with federal income taxes. After all, most adults must deal with federal income taxes at some level each year. But federal transfer taxes, e.g., gift, estate, and generation skipping taxes, are a different matter altogether.

For the most part, they only affect people of high net worth; and even then, it is typically just the professionals who assist persons of high net worth who actually deal with the tax issues.

As a professional who works with high net worth clients, it is important that you have some understanding of federal transfer taxes. In fact, to have even the most basic understanding of estate planning requires some knowledge of transfer taxation.

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| Objectives  This course is designed to provide a basic understanding of federal transfer taxes in an efficient and effective manner. Once that is established, a companion course will introduce you to trusts and some of the primary estate planning techniques available. In this course, you will obtain a basic understanding of the federal gift and estate tax system, with emphasis on:   * Elements that are common to both gift and estate taxes, as well as elements that are unique to each * Generation-Skipping Transfer Taxes and how to identify “skip” persons * The types of joint property and their estate planning implications * Gift, Estate, and Income taxation of transfers to charities * Tax basis treatment of assets transferred upon death |

## The Federal Transfer Tax System

**Tax on the Transfer of Assets**

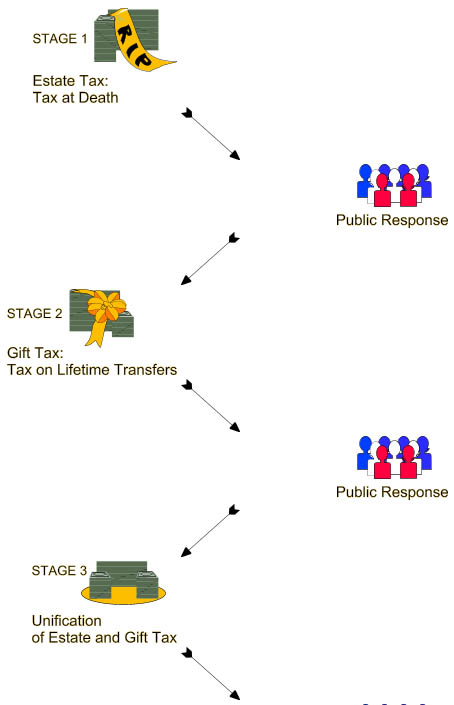
Federal Gift, Estate, and Generation-Skipping Transfer taxes compose what is commonly referred to as the federal "Transfer Tax System" because they deal with the taxation applied to the transfer of assets. Although there are exceptions, some of which will be addressed in this training, any transfer of assets from one party to another is potentially a taxable event. Knowing when these taxes apply is crucial.

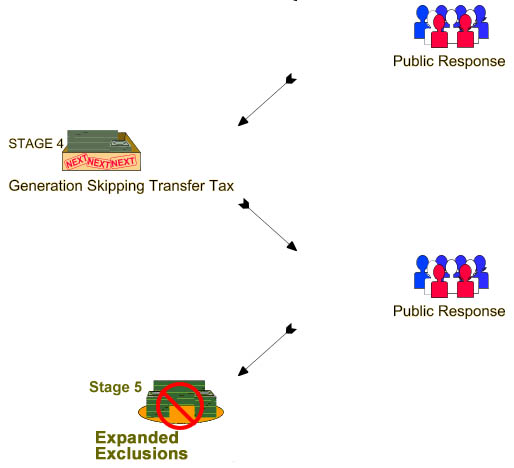
**Gift, Estate, and Generation-Skipping Transfer Taxes Have Much In Common**

At one point in our history, lifetime transfers (gift taxes) were taxed under a system that was totally separate from the taxation of transfers upon death (estate taxes). However, beginning in 1976, the estate tax and gift tax were "unified " into a combined system and have shared many common elements since that time. But there are also elements that are unique to each. This course will begin by introducing the common elements of gift and estate taxes, followed by some of the unique characteristics of each. It will then introduce the taxation of transfers that skip a generation, which also shares some common elements with gift and estate taxes.

**The History of Transfer Tax**

**Click on each Stage and Public Response to learn more.**





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| **Stage 1 Estate Tax: Tax at Death**  In 1916, Congress approved the implementation of an estate tax as a "temporary measure" to raise revenue. |

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| **Stage 1: Public Response**  As this "temporary measure" became more permanent, people began looking for ways to avoid the tax. The answer was simple enough: simply transfer assets before you die. If you did not own it when you died, then no tax was due. |

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| **Stage 2 Gift Tax: Tax on Lifetime Transfers**  To curtail efforts to avoid taxation by making lifetime gifts, Congress enacted a gift tax in 1924. This gift tax co-existed with the estate tax. Two aspects of this arrangement are important for understanding the evolution into our current form of taxation:   1. **The tax rate on gifts was 25% lower than the rate for estates.** 2. **Both taxes were independent of the other**. In other words, each calculation took place with no consideration of the other. |

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| **Stage 2: Public Response**  Because the gift tax was less, the public continued to have an incentive to explore ways to make lifetime transfers, particularly through trusts, and avoid the estate tax with its higher rate. |

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| **Stage 3 Unification of Gift and Estate Tax**  Seeking to do away with the preferential tax treatment of lifetime transfers, the Tax Reform Act of 1976 created the Unified Gift and Estate Tax. This "unified" approach continues to this day. Its features include:   1. **A single tax rate** that is used for calculating both gift and estate taxes. 2. **Consideration of lifetime transfers when computing the estate tax**. In other words, lifetime gifts (after 1976) are added back into the estate when computing the estate tax. A credit is then given for any gift taxes that were paid. |

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| **Stage 3: Public Response**  Another way people had learned to avoid transfer taxes was to make transfers that skipped entire generations.  **Example.** Suppose you have three generations: Parent, Child, and Grandchild. Further suppose that your ultimate goal is to keep everything in the family and transfer assets to the grandchild. This could be accomplished in two ways.  **Transfer through the child.** Here, the Parent makes a transfer to the Child, who subsequently transfers assets to the original donor's Grandchild. This results in **two taxable transfers**, one for each successive generation.  **Transfer directly to the grandchild**. Here, the Parent skips the next generation and transfers assets directly to the Grandchild. Only **one taxable *transfer*** is made.  This skipping of generations became a popular approach to minimizing taxes, and trusts were particularly useful vehicles for accomplishing multigenerational transfers. |

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| **Stage 4 Generation-Skipping Transfer Tax**  To address the attempts to avoid the tax by skipping generations, the Tax Reform Act of 1976 also introduced a generation skipping tax that severely curtailed the ability to skip generations without paying a tax. This tax, when applicable, is in addition to any gift or estate tax that may be applied. |

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| **Stage 4: Public Response**  After the boom of the 1990's, there was increased political pressure to raise the amount of an estate that could be transferred free of taxes, with many politicians pushing for the total elimination of the estate tax. |

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| **Stage 5 Expanded Exclusions**  In the year following the Tax Reform Act of 1976, the tax rate schedule that was used to calculate the gift and estate tax went as high as 70% on amounts over $5,000,000. However, a tax credit was available to protect the first $120,000 of taxable transfers from actually having to pay a tax.  With continued political pressure and numerous tax acts later, the tax rate schedule that is currently used to calculate the tax has a maximum rate of 40% on amounts over $1,000,000. Furthermore, for 2016 the available lifetime credit to each person protects the first $5,450,000 (indexed for inflation). This represents a significant rate reduction and a significant expansion of the credit to offset the gift and estate tax.  We will have more to say about the current tax environment on the following pages. |

## The Gift and Estate Unified Rate Schedule

Having done a brief overview of the history of transfer taxes, we now turn our attention to the current status of federal gift and estate taxes. We first focus on those elements that are common to both gift and estate taxes.

Listed below is the current Federal Unified Rate Schedule that is used in calculating the transfer tax on both lifetime gifts and estates. Under current law, this schedule remains constant for future years.

**Click the highlighted row to learn more.**

**CURRENT UNIFIED GIFT & ESTATE RATE SCHEDULE\***

|  |  |  |  |
| --- | --- | --- | --- |
| Column A  Taxable amount over | Column B  Taxable amount not over | Column C  Tax on amount in Column A | Column D  Rate of tax on excess over amount in Column A |
| $0 | $10,000 | $0 | 18% |
| 10,000 | 20,000 | 1,800 | 20% |
| 20,000 | 40,000 | 3,800 | 22% |
| 40,000 | 60,000 | 8,200 | 24% |
| 60,000 | 80,000 | 13,000 | 26% |
| 80,000 | 100,000 | 18,200 | 28% |
| 100,000 | 150,000 | 23,800 | 30% |
| 150,000 | 250,000 | 38,800 | 32% |
| 250,000 | 500,000 | 70,800 | 34% |
| 500,000 | 750,000 | 155,800 | 37% |
| 750,000 | 1,000,000 | 248,300 | 39% |
| 1,000,000 | ---- | 345,800 | 40% |

*\*This schedule is for 2013 and subsequent years.*

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| Let’s look at an example. Suppose you wish to calculate the transfer tax on $120,000. Here is how you do it:  **Step 1** – Find the row where $120,000 is between the number in Column A and the number in Column B. As you can see, it is the 7th row, where the range between Column A and Column B is $100,000 to $150,000.  **Step 2** – Identify the tax on the $100,000 amount given in Column A. This is provided in Column C, where we see that the tax on $100,000 is $23,800.  **Step 3** – Now calculate the tax on the amount over $100,000 using the rate found in Column D. Since our amount is $20,000 over the $100,000 for which we have already been provided the tax amount, multiply $20,000 by 30% to get $6,000.  **Step 4** – Add together the tax from Step 2 and Step 3. Thus our tax on the first $100,000 plus the tax on the next $20,000 equals $23,800 + $6,000, for a total tax of $29,800. |

***Make note of the highest tax rate: 40%.*** This is achieved on all amounts over $1 million. This has not always been the highest rate. As previously discussed, this rate has been much higher in the past. Current legislation, however, dictates that this rate schedule remain fixed unless changed by future legislation.

## Practice – Using the Gift and Estate Rate Schedule

To develop some comfort in working with the Unified Gift and Estate Rate Schedule, use the schedule to answer the questions that follow:

**CURRENT UNIFIED GIFT & ESTATE RATE SCHEDULE\***

|  |  |  |  |
| --- | --- | --- | --- |
| Column A  Taxable amount over | Column B  Taxable amount not over | Column C  Tax on amount in Column A | Column D  Rate of tax on excess over amount in Column A |
| $0 | $10,000 | $0 | 18% |
| 10,000 | 20,000 | 1,800 | 20% |
| 20,000 | 40,000 | 3,800 | 22% |
| 40,000 | 60,000 | 8,200 | 24% |
| 60,000 | 80,000 | 13,000 | 26% |
| 80,000 | 100,000 | 18,200 | 28% |
| 100,000 | 150,000 | 23,800 | 30% |
| 150,000 | 250,000 | 38,800 | 32% |
| 250,000 | 500,000 | 70,800 | 34% |
| 500,000 | 750,000 | 155,800 | 37% |
| 750,000 | 1,000,000 | 248,300 | 39% |
| 1,000,000 | ---- | 345,800 | 40% |

*\*This schedule is for 2013 and subsequent years***.**

Enter your results in the blank space provided and click the Submit button.

* Tentative Tax on a transfer of $150,000 = **$38,800**

**Correct!** The answer is $38,800

**Incorrect.** To find the correct tax, follow these steps:

**Step 1**. Locate the row where $150,000 falls within the range given in the first two columns. This occurs in the range of $150,000 to $250,000.

**Step 2.** The third and fourth columns indicate the tax would be $38,800 plus 32% of any amount over that listed in Column A ($150,000). Since our estate is exactly $150,000, there is nothing further to calculate, so the tentative tax is $38,800.

* Tentative Tax on a transfer of $350,000 =**$104,800**

**Correct!** The answer is $104,800.

**Incorrect**. To find the correct tax, follow these steps.

**Step 1**. Locate the row where $350,000 falls within the range listed in Columns A and B. The appropriate range is $250,000 to $500,000.

**Step 2.** Columns C and D indicate that the tax is $70,800 plus 34% of any amount over $250,000. That leads to the following tax calculation:

Tentative Tax = 70,800 + .34(350,000 – 250,000) = 70,800 + 34,000 = $104,800

Next, identify the marginal rates for the following amounts:

* **Marginal rate** on a transfer of $450,000 = **34%**

**Correct!** The answer is 34%.

**Incorrect**. To find the correct answer, follow these steps:

**Step 1.** Locate the row where $450,000 falls within the range given by Columns A and B. The appropriate range is $250,000 to $500,000.

**Step 2.** Column D gives the marginal rate being charged on every dollar over $250,000 as 34%. Thus, the marginal rate for $450,000 is 34%.

* **Marginal rate** on a transfer of $4,500,000 = **40%**

**Correct!** The answer is 40%.

**Incorrect.** To find the correct answer, follow these steps:

**Step 1.** Locate the row where $4,500,000 falls within the range given by Columns A and B. The appropriate range is in the last row, which includes everything from $1,000,000 and above.

**Step 2.** Column D gives the marginal rate being charged on every dollar over $1,000,000 as 40%. Thus, the marginal rate is 40%.

## Why Unify the Gift and Estate Tax?

One of the goals in creating a unified gift and estate tax system was to ultimately have everyone make the same transfer tax calculation regardless of the timing of the transfers. Just how this is accomplished is illustrated in the following example.

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| **Mr. Jones’ Story**  Mr. Jones made a taxable gifts during his lifetime (after 1976) of $800,000. He died in 2016 with an estate valued at $6,200,000. How do you take into account his lifetime gift in computing his estate tax?  DocumentationIcon_32px  **Click the icon for the answer.**   |  | | --- | | **Answer**:  First, add together his lifetime taxable gifts (those made after 1976) and his final estate value, deriving a total of $7 million. Then compute the tax on $7 million, deriving his tentative estate tax.  If he paid any prior tax on his lifetime gifts (a likelihood if the bulk of his taxable gifts were made prior to 2002 when the cumulative amount that could be gifted without paying a tax was less than the cumulative $800,000 he gifted), then give him a credit in that amount against his estate tax.  The result is that Mr. Jones’ estate tax is calculated on $7,000,000, which is the same amount he would have used if he had never made lifetime taxable gifts (ignoring potential market value changes). This illustrates how two people with the same size estate will ultimately make the same estate tax calculation, even though one person made lifetime taxable gifts and the other did not. To be sure, there may be value in getting assets out of your estate during life because the appreciation on those assets will not be in your estate when you die; but ignoring market value changes, the tax calculation itself will be the same. | |

The concept illustrated by the example above is very important to remember. ***Lifetime taxable gifts (made after 1976) are added back whenever a federal gift or estate tax return is filed.*** Thus, the calculation is always a cumulative calculation of all taxable transfers since 1976. A credit, which we will discuss later, is available against the calculated tax. Furthermore, if any gift taxes were previously paid on lifetime transfers, then credit against the current tax calculation will also be given for prior taxes paid.

## The Applicable Credit Amount

Every U.S. citizen and **resident alien (non-citizen resident)** has a lifetime ***credit*** against gift and estate taxes; it is typically referred to as the “***Applicable Credit Amount***.” A “credit” is an amount that you get to ***subtract after a tax is calculated***. So, once we calculate a tentative transfer tax, we get to subtract the credit from the calculated tax.

The Applicable Credit Amount is “***unified***,” meaning it is shared with lifetime transfers (i.e., gifts) and estate transfers (i.e., at death); for this reason, you will sometimes see the Applicable Credit Amount referred to as the “***Unified Credit***.” Thus, the credit can be used to offset calculated gift or estate taxes; but if it is all used up by lifetime taxable gifts, there will be no credit left to protect further assets that transfer at death.

Historically, the Applicable Credit Amount has not always been fully unified between gift and estate taxes. In other words, there have been times in the past when only a portion of the Applicable Credit Amount could be used for lifetime taxable gifts; but today, there is no limit on how much of the credit can be used while alive.

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| **Resident Alien (Non-Citizen Resident)**  For transfer tax purposes, a non-citizen person is considered a resident alien and domiciled in the United States if the person lives in the United States with no present intention of leaving the United States. Various factors, such as statements of intent, length of time in the U.S., visa status, etc.) are used to determine domicile. Resident aliens are generally under the same gift and estate tax rules as U.S. citizens and are subject to taxation on their ***entire estates wherever situated***. |

## The Applicable Exclusion Amount

The amount of assets that are protected from taxation by the Applicable Credit Amount is known as the ***Applicable Exclusion Amount***. Stated another way, the Applicable Exclusion Amount is that amount of taxable transferred assets that will result in a tax bill equivalent to the Applicable Credit Amount, resulting in zero taxes owed to the IRS.

In recent years, the Applicable Credit Amount and corresponding Applicable Exclusion Amount available to U.S. citizens and resident aliens have grown considerably. For example, in the decade between 2001 and 2011, we saw the following change:

|  |  |  |
| --- | --- | --- |
| Year | Applicable Credit Amount | Applicable Exclusion Amount\* |
| 2001 | $220,550 | $675,000 |
| 2011 | $1,945,800 | $5,000,000 |

*\*The amount of assets that are protected from taxation by the Applicable Credit Amount.*

In just 10 years, we went from being able to make $675,000 of taxable transfers to making $5,000,000 of taxable transfers without having to pay a single dollar of federal gift and estate taxes. This led to a dramatic decrease in the number of estates that owed gift and estate taxes, and an equally dramatic lowering of concern by most Americans regarding depletion of their estates by estate taxes.

For years following 2011, the growth of the Applicable Credit/Exclusion Amounts has slowed. This is because legislation fixed the Applicable Credits and Exclusion Amounts to 2011 levels, but began adjusting the amount for inflation. Today, their inflation-adjusted values are:

|  |  |  |
| --- | --- | --- |
| Year | Applicable Credit Amount | Applicable Exclusion Amount |
| 2016 | $2,125,800 | $5,450,000 |

While you need not memorize the Applicable Credit Amount, you should commit the Applicable Exclusion Amount to memory. Knowing this amount will be extremely useful in evaluating the tax exposure of any given estate.

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| ***Illustration*:**  In 2012, James, a widower since 1995, made a $1,000,000 taxable gift to his children. He had made no prior taxable gifts and had no transfer tax credits other than his own Applicable Credit Amount.  Next, in 2014, he made another $1,000,000 taxable gift to his children.  Finally, he died in 2016 with a taxable estate valued at $10,000,000. How much of his estate was *NOT* protected by his Applicable Credit/Exclusion Amount?  **Try for the answer yourself and then click here for our analysis.**   |  | | --- | | ***Analysis****:*  James filed a gift tax for the 2012 gift, calculating a tax of $345,800. But his Applicable Credit Amount was more than enough to cover the tax, so no tax was due to the IRS.  When he filed the gift tax return for the 2014 gift, he ***added together the 2012 and 2014 gifts*** (remember, all post-1976 taxable gifts must be added back for both gift tax returns and estate tax returns). Thus, he reported his cumulative lifetime taxable transfers of $2,000,000, with a calculated tax of $745,800. Again, no tax was due because his Applicable Credit Amount was more than enough to cover the tax.  Upon his death, the executor added all post-1976 taxable gifts ($2,000,000) to the value of his estate ($10,000,000), and calculated the tax on the combined $12,000,000. The 2016 Applicable Credit of $2,225,800 was sufficient to protect the first $5,450,000 (in this case, the $2,000,000 of lifetime taxable gifts and $3,450,000 of his estate at death). Tax would be due, however, on the remaining $6,550,000 of his estate. Since this will be taxed at the marginal rate of 40%, James’ executor will pay the IRS: $6,550,000 x 40% = $2,620,000. | |

### What about Nonresident Aliens?

Unlike U.S. citizens and resident aliens, who have a generous unified Applicable Exclusion Amount for use with both lifetime gifts and estate transfers, **nonresident aliens** have an Applicable Exclusion Amount that can only be used for at-death transfer of their estates. Furthermore, the estate-only Applicable Exclusion Amount for nonresident aliens is limited to **$60,000**. This amount is **NOT adjusted for inflation**.

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| **Nonresident Alien**  All non-citizens who do not meet the test for being a resident alien are classified as non-resident aliens, even though they may be living in the United States for an extended period of time. They are subject to federal gift and estate tax only on their ***U.S. “situs” assets***.Unless modified by treaty, this generally includes real and tangible personal property located in the U.S., business assets located in the U.S., and stocks. |

## 

## Deductions: Unlimited Marital and Charitable

Unlike the Applicable Credit Amount, which is applied after the tentative tax on the gift or estate is calculated, there are certain deductions that actually reduce the taxable amount of the gift or estate ***before*** the tentative tax is calculated. Two important deductions that are available for both gift and estate taxes are:

1. **The Unlimited Marital Deduction** - Transfers of assets to U.S. citizen spouses are non-taxable events regarding gift and estate taxes due to a “marital deduction” that is provided on the gift or estate tax form. This marital deduction is *unlimited*, so any amount can be transferred to U.S. citizen spouses during life or at death without triggering a gift or estate tax.

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| Beware, however, if a spouse is not a U.S. citizen. Non-U.S. citizen spouses are not automatically entitled to the Unlimited Marital Deduction and additional planning must be done in order to get them in a position to receive assets free of estate taxes. |

1. **Charitable Deductions -** Transfers to qualified charities, during one's lifetime or at death, are not subject to transfer taxes.

## ****Review****

**We have covered a lot of facts to this point, so let’s do a quick review of key facts.**

**Click each topic below to review key facts. Do not proceed forward until you have committed these to memory.**

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| **Unified Transfer Tax Rates** |
| * The same rate schedule is used for gifts and estates. * Lifetime taxable gifts and final estate assets are aggregated to calculate the tentative estate tax. * The maximum scheduled rate for 2016 is 40%. |
| **Applicable Credit / Exclusion Amount** |
| * Only the Applicable Credit is used in the actual tax calculation. * The Exclusion Amount illustrates the value offset by the Applicable Credit. * The Applicable Exclusion Amount for gifts AND estates = $5,450,000 for 2016. * Currently, the full Applicable Exclusion Amount can be used for lifetime gifts. * The first dollar on which a tax is actually paid to the IRS on taxable transfers in 2016 is at the 40% rate. |
| **Deductions** |
| * Deductions are taken before the tax is calculated. * The amount that can be transferred between spouses without a transfer tax is unlimited(provided they are U.S. citizens)**.** * Transfers to Charities are not subject to transfer taxes. |

## Review Exercise

**For the following statements, click on the correct response:**

1. **Gift taxes are computed using the same rate schedule as for estates:**

* **True**

**Correct.** The Gift and Estate tax use the same rate schedule.

* **False**

**Incorrect.** The Gift and Estate tax actually do use the same rate schedule.

1. **The amount that can be transferred between spouses without incurring a transfer tax is:**

* **Limited**

**Incorrect**. The amount that can be transferred between spouses without generating a transfer tax liability is generally unlimited**.**

* **50%**

**Incorrect.** The amount that can be transferred between spouses without generating a transfer tax liability is generally unlimited**.**

* **Unlimited**

**Correct.** There is generally no limit to the amount spouses can transfer between each other without generating a transfer tax liability.

1. **When computing the gift or estate tax, lifetime gifts made after 1976 are added back to the tax return before computing the tax:**

* **True**

**Correct**. This makes it possible to have a unified gift and estate tax system.

* **False**

**Incorrect.** Each tax return calculation is inclusive of lifetime transfers since 1976.

1. **Transfers to charities ARE NOT excluded from estate or gift taxation:**

* **True**

**Incorrect.** They are in fact excluded from gift and estate taxes.

* **False**

**Correct.** They are in fact excluded from gift and estate taxes.

1. **The gift and estate Applicable Exclusion Amount for 2016 is:**

* **$10,000**

**Incorrect.** Try again.

* **$12,000**

**Incorrect.** Try again.

* **$14,000**

**Correct.**

* **$28,000**

**Incorrect.** This is the amount for a couple who are splitting their gifts. Try again.

1. **The maximum marginal rate on the current Unified Gift and Estate Tax Rate Table is:**

* **18%**

**Incorrect.** This is the minimum rate on the schedule. Try again.

* **40%**

**Correct**.

* **50%**

**Incorrect.** Try again.

* **70%**

**Incorrect**. This was true in 1977, but not today. Try again.

## Unique Characteristics of Gift and Estate Taxes

Thus far, we have reviewed rules that are common to both estates and gifts. Let’s now examine some of the characteristics and rules that are unique to each. The following is a roadmap of the topics we want to cover.

**Click on each heading to learn more.**

|  |
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| **Characteristics Unique to Gifts** |
| * What Constitutes a Gift * Annual Gift Tax Exclusion * Exclusion for Tuition * Medical Care Exclusion |
| **Characteristics Unique to Estates** |
| * Gross Estate * Estate Tax Due Date * Alternative Valuation Date * Portability of the Applicable Exclusion Amount Between Spouses |

## What Constitutes a Gift?

Generally speaking, a transfer is considered a gift when one of the following conditions listed below are met.

|  |  |
| --- | --- |
| **Overview** | **Click on each condition on the left to view more information.** |
| **Both parties are competent adults** | Just as minors need a guardian or other entity such as a trust to hold property on their behalf, so do adults who are incompetent. |
| **It is not an equal value exchange** | As the IRS Code states, the transfer must be "for less than an adequate and full consideration in money or money's worth."  If payment for the full value of the transfer is received, it is not a gift. If partial payment is received with no requirement for further payment, then it is a partial gift of the balance. |
| **It is a completed transfer** | This means that actual receipt of the asset was taken or title to the property was changed. It also means that no strings are attached whereby the donor retains control or use of the asset. In the latter case, such gifts are considered incomplete. |
| **The transfer is irrevocable** | This means that once it is given, it can't be taken back. |

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| **What You Need to Know about Gifts**  Given these conditions, many things can qualify as a gift:   * Gifts of cash * Gifts of investment securities, such as stocks or bonds * Forgiveness of a loan * Purchasing an automobile or computer as a graduation present * Creation of certain types of trust for the benefit of someone else |

## https://learning.greeneconsults.com/topclass/greene/transfer_taxes/images/18.gifAnnual Gift Tax Exclusion

Fortunately, not every gift to an individual is taxable. We previously discussed the fact that transfers to a spouse or to a qualified charity are excluded from both gift and estate taxes. We will now examine three additional lifetime gifts that are excluded from gift taxes. What is especially important to remember about these three types of excluded gifts is that they not only escape gift taxation when gifted, they also generally are never added back to the estate as post-1976 gifts when we die.

The first of these are ***annual exclusion gifts***.

For 2016, lifetime gifts of a present interest in the amount of **$14,000 or less** can be made **annually to any individual,** and are **excluded** from the gift tax; this is known as the ***annual gift tax exclusion***. Note that the gift tax exclusion is not limited to gifts to family members; it applies to gifts to ANY INDIVIDUAL. This gift tax exclusion is available each year, making it possible to make repeat gifts to the same person in subsequent years. The amount is also indexed for inflation.

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| present interest  The recipient enjoys an immediate benefit and the unrestricted right to use, possess, and enjoy the property. |

This provides a significant ability for individuals with taxable estates to effectively transfer assets out of their estates without incurring a transfer tax. Given sufficient doneesand sufficient years to make transfers, sizeable amounts can effectively avoid taxation.

|  |
| --- |
| donees  Person or institution to whom a gift is made. |

|  |  |
| --- | --- |
| **Overview** | Factors to keep in mind when considering annual exclusion gifts include the following: **Click each heading on the left.** |
| **There is No Limit to the Number of Gifts in a Year** | An individual can make $14,000 annual exclusion gifts to as many people as desired. |
| **Gifts can be Made to Anyone** | The gift tax exclusion is not limited to gifts to family members. It applies to gifts to ANY INDIVIDUAL. |
| **It is Not Cumulative** | In other words, it is either used or lost. If a year is skipped, the individual is not allowed to carry it forward into a subsequent year. |
| **Indexed for Inflation** | Beginning in 1999, the exclusion was set at $10,000 and indexed for inflation using 1997 as the base year. The indexing is rounded down to the next lowest multiple of $1,000, meaning it may be a number of years between changes. For 2016, it is $14,000. |
| **Gift-Splitting** | Spouses who are U.S. citizens or resident aliens can “elect to” or “consent to” split gifts between them for a combined $28,000 (in 2016) to any individual, and the entire amount qualifies for the annual gift tax exclusion. This is true even if the source of the funds is entirely from one spouse. A gift tax return *must* be filed when electing to split a gift.  *Note*: A spouse who is a non-resident alien cannot make a gift-splitting election. |
| **No Gift Tax Return Required (unless splitting gifts)** | There is a *de minimus* rule in regard to record keeping. For gifts of $14,000 or less (in 2016), no gift tax return need be filed, provided gift-splitting is not involved. Just keep personal records; no reporting is necessary. Of course, if the gift exceeds the Annual Exclusion Amount, a tax return must be filed, but you will be able to subtract the annual exclusion amount before computing the tax and would only carry forward the excess on future tax returns (when adding back post-1976 gifts). |
| **Gifts to a Non-Citizen Spouse** | Normally, gifts between spouses qualify for the unlimited marital deduction and are nontaxable events for gift tax purposes; but the unlimited marital deduction does not apply for a gift to a spouse who is not a U.S. citizen (either resident alien or nonresident alien).  To mitigate this, an expanded Annual Exclusion Amount of $148,000 (in 2016, as indexed) is allowed for gifts to a non-citizen spouse. This amount is indexed for inflation. |

## Other Gift Tax Exclusions

In addition to the Annual Gift Tax Exclusion, there are two other important lifetime transfers (direct payment of tuition and direct payment of medical care) that are not subject to gift taxation. Including gifts to a spouse or to a charity, that gives us a total of five ways we can make lifetime gifts that are “not taxable gifts” and which, being non-taxable, will NOT be added back to the taxable estate when the person dies. All other gifts are generally classified as “taxable gifts”, even though no tax may actually be paid because of the lifetime credit against gift taxes, and these taxable gifts are added back to the donor’s estate upon death.

**For the basic characteristics of each, click on each item below.**

|  |
| --- |
| **Direct Payment of Tuition** |
| * It is limited to tuition (books, dormitory, student fees, etc. do not qualify). * Payment must be made directly to the school (it cannot be given to the student with the intent that the student would pay the tuition). * There is no limit on the amount. * This is in addition to the annual gift tax exclusion. * Payment can be for anyone. |
| **Direct Payment of Medical Care** |
| * The IRS defines specific expenses that qualify, but in general they cover the expenses of diagnosis and treatment. * It is not allowed for amounts reimbursed by insurance. * Payments must be made directly to the doctor or health care facility providing the care. * There is no limit on the amount. * This is in addition to the annual gift tax exclusion. * Payment can be for anyone. |

## What is Included in the Gross Estate?

We now turn our attention to what is unique to estate taxes. As we do so, don't confuse the taxable estate with the probate estate. The probate process involves the court supervision of the administration of the will, payment of creditors, changing titles to property, and the distribution to heirs. The estate tax process includes all the assets that are probated, but there are other assets owned by the deceased that do not go through probate, yet are included in the estate tax return. Primary examples are life insurance, retirement accounts, and jointly owned property.

|  |
| --- |
| **Probate estate**  Portion of the estate that goes through the probate process. |

Unless an extension is obtained, **the estate tax return is due 9 months after the date of death.** The first step in computing the estate tax is to identify all assets that are included in the **gross estate** (before adjustments) and record them on **Form 706** (the form used for the Estate Tax Return). Essentially, everything owned by the deceased person is included in the gross estate.

It also includes any ***life insurance*** owned by the deceased, which might surprise many people. Interestingly enough, life insurance that is on the life of the deceased is includable at its full face amount, not at its lesser cash value that the deceased could have sold it for just prior to death. This is often a considerable percentage of a person's estate. For this reason, it is often advisable to transfer ownership of life insurance to another person or to an irrevocable trust, to get it out of one's estate (assuming this can be accomplished without having to pay a gift tax).

Note, however, that certain transfers ***within three years of death*** are deemed to be "in anticipation of death", and are still included in the original owner's estate. This applies to Life Insurance! Thus, to successfully transfer life insurance out of your estate, you must transfer it to another and then live for three more years.

Also included in the gross estate are “***incomplete transfers***” of property where the person retained certain rights over the property. Examples of incomplete transfers would include those where the person making the transfer retained the right to the income on the property, the right to continue using the property, or the right to control who else would get the income or be able to enjoy the property.

## What about Joint Property?

Property is not always owned outright by a single individual. The inclusion of property in the taxable or probate estate is greatly impacted on how the property is owned. There are four types of co-ownership of property listed below:

|  |
| --- |
| **What You Need to Know about Joint Property**  For each type of co-ownership of property, it is important to have knowledge of the following points:   * Where does the property exist? * The number of permissible owners * The relationship of owners, if any * The nature of each person's ownership * What happens when an owner dies? * How the property is taxed? |

**Click on each co-ownership of property type to view more information.**

|  |
| --- |
| **Joint Tenancy (with Right of Survivorship)** |
| **How many owners are allowed?** Two or more.  **What is the relationship of the owners?** None required, but they may be related.  **What is the extent of each person's ownership interest?** Each co-owner has an equal, undivided interest. If there are two owners, they each own ½. If there are three owners, they each own 1/3.   |  | | --- | | undivided interest  An **undivided interest** is where each co-owner has an ***interest in the entire property***, not just ownership of a piece of the property.  For example, if two individuals own an undivided interest in an acre of land, each owner has an ownership interest in the entire acre, rather than one owning the northern half and the other owning the southern half. Each owner, therefore, has the right to make use of the entire acre, not just a piece of it. |   **What happens when an owner dies?** Property that is titled in this way does not have to be probated upon death. The owner’s interest automatically passes to the surviving co-owners. For example, if there were four owners, each with ¼ interest in the property, then when one dies the other three co-owners would have 1/3 interest in the property.  **How is it taxed?** The estate tax consequences of Joint Tenancy depend upon whether or not the joint tenants are married:   * **Non-Spousal Joint Tenancy** - If they are not married (non-spousal) and one owner dies, the IRS will generally presume that the decedent owned 100% of the property. The only way to keep the full amount from being included on the tax return is to prove that the surviving joint tenant(s) contributed funds for its acquisition. If such evidence can be furnished, then the decedent's interest in the property would be reduced to the percentage of the purchase that was actually supplied by the decedent. * **Spousal Joint Tenancy** - For couples married after 1976 and acquiring joint property after that date, ½ of the property is included in the decedent's taxable estate, regardless of the source of funds with which the purchase was made. Be aware that some courts have ruled that if the couple married prior to 1977 and acquired joint property prior to 1977, then the property is treated just as non-spousal Joint Tenancy. Also, be aware that these rules do not apply if the decedent’s spouse is not a U.S. citizen (unless the foreign spouse’s interest is held in a qualified domestic trust). |
| **Tenants by the Entirety** |
| **How many owners are allowed?** Two.  **What is the relationship of the owners?** They must be husband and wife.  **What is the extent of each person's ownership?** Each spouse has an equal (½) undivided interest in the property.  **What happens when one owner dies?** Property that is titled in this manner does not go through probate. Full ownership immediately goes to the surviving spouse.  **How is it taxed?** The estate tax consequences are exactly the same as for Spousal Joint Tenancy (see Joint Property above). |
| **Tenants in Common** |
| **How many owners are allowed?** Two or more.  **What is the relationship of owners?** None required, but they may be related.  **What is the extent of each person's ownership?** Each person holds a percentage interest in the property, the size of which can vary among the co-owners. Usually, their ownership interest is proportional to their contribution to the purchase of the property. Here too, their interest in the property is undivided.  **What happens when one owner dies?** This type of ownership does not bypass probate, unless it is held in trust. Nor does the owner's interest terminate at death. While alive, each owner has the right to transfer his/her percentage interest at any time, to whomever they wish, independently of the other owners. In like manner, at death, their interest will be distributed according to the terms of their will.  **How is it taxed?** Only the percentage interest that is owned by the decedent is included in his/her estate. In other words, their interest is treated just as if they owned their portion independently of the other owners. |
| **Community Property** |
| In most community property states, community property is not a function of how the property is titled. Rather, it is a function of where a married couple resides when the property is acquired. With certain exceptions, everything received by a husband and wife while residing in a community property state is considered to be owned 50-50. When they move out of a community property state, community property will maintain its character as community property, as will any assets that are bought with community property. However, in Alaska couples must elect community property treatment.  **Where does Community Property exist?** Only in 10 states: Alaska (optional), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin  **How many owners are allowed?** Two.  **What is the relationship of owners?** Applies only to married couples.  **What is the extent of each person's ownership?** With some exceptions that are discussed in a separate course on Community Property, each spouse owns half of all property acquired during marriage.  **What happens when one owner dies?** Community Property is subject to probate. When one spouse dies, their half interest in the property will be distributed as instructed in the will.  **How is it taxed?** Half of the community property is included in the deceased spouse’s estate for estate tax purposes. Normally, only property that is included in the taxable estate receives a step-up in its tax basis to current market value upon death. But community property is unique in that respect. Although only half of it is included in the taxable estate, the entire amount of the community property will generally receive a step-up in basis. |

## Valuation

In determining the value of property that is included in the estate tax return, the valuation used can either be at the time of death, or an election can be made to use the **alternate valuation date**, which is **6 months after death**. But the alternate valuation date can only be used if it results in lower taxes. Any assets that are distributed or sold prior to the alternate valuation date will use the value at which they were distributed or sold.

All valuations must be at fair market value. Determining a fair market value is not always simple. While beyond the scope of this course, be aware that there are many rules regarding how to determine the value of various assets.

## Portability of the Applicable Exclusion Amount

Beginning in 2011, a new concept was introduced to the federal gift and estate tax laws known as the “***portability***” of the Applicable Exclusion Amount. By “portability,” we mean that it is now possible for the unused portion of a deceased spouse’s Applicable Exclusion Amount to be transferred (or transported over) at death to the surviving spouse. For this to apply, the death had to occur after 2010.

Stated differently, when one spouse dies, the surviving spouse has their own “Basic” Exclusion Amount PLUS the ***“Deceased Spousal Unused Exclusion (DSUE) Amount.”***  If someone is predeceased by more than one spouse, then it is the ***last deceased spouse*** for whom this portability applies.

This change significantly impacts estate planning and makes it possible for a surviving spouse to have a significantly enhanced Applicable Credit/Exclusion Amount for use on the estate tax return. To make use of it, the executor simply files an estate tax return and chooses to not opt out of portability on the return. Furthermore, portability is available for both U.S. citizen and resident alien spouses; it is not available to nonresident aliens.

|  |  |
| --- | --- |
| **Overview** | While this sounds simple, it can actually get a bit complicated. Fortunately, this added complexity makes for some planning risks and opportunities. The best way to illustrate this is with several similar examples, going from the simple to the more complex. Study these examples carefully, as they illustrate some important planning considerations regarding portability.  **Click each example to learn more.** |
| **Example 1** | Mr. Andrews died in 2012 when his Applicable Exclusion Amount was $5,120,000. He never made any lifetime taxable gifts and passed his entire estate on to his wife, using the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to her.  Mrs. Andrews died in 2016. She, too, had never made any lifetime taxable gifts, so the Applicable Exclusion Amount available to her estate equaled her own 2016 Basic Exclusion Amount of $5,450,000 plus the $5,120,000 DSUE Amount she received from her deceased husband, for a combined total of $10,570,000. ***Please note that her Basic Exclusion Amount (i.e., her own Applicable Exclusion Amount) was increased by inflation from 2012 to 2015, while the DSUE Amount she received from her deceased husband remained fixed by the year of his death.*** |
| **Example 2** | Jane’s first husband died in 2012 when his Applicable Exclusion Amount was $5,120,000. He had never made any lifetime taxable gifts and passed his entire estate on to Jane, utilizing the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to Jane.  Jane remarried in 2014 and her second husband died in 2015. Jane’s second husband had a will that left his entire estate of $10,000,000 to his children from a prior marriage, totally using up his entire Applicable Credit/Exclusion Amount and transferring no DSUE to Jane.  Jane died in 2016. According to the rules of portability, her estate can no longer use the $5,120,000 DSUE she received from her first husband’s estate because the rules dictate that her estate can only use the DSUE from her ***last deceased spouse***. Unfortunately, her last deceased spouse’s estate left her with no DSUE. Thus, her estate is left solely with her own Basic Applicable Exclusion Amount of $5,450,000.  ***This example highlights a risk associated with DSUE and remarriage. In the next example, we will see a planning technique that can potentially address that risk.*** |
| **Example 3** | Sarah’s first husband died in 2012 when his Applicable Exclusion Amount was $5,120,000. He had never made any lifetime taxable gifts and passed his entire estate on to Jane, utilizing the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to Sarah.  Sarah remarried in 2014. Immediately upon remarriage, she made taxable gifts in the amount of $5,120,000 to her children from her prior marriage. The rules dictate that when a surviving spouse with DSUE makes lifetime taxable gifts, the DSUE is used up before the surviving spouse’s own Basic Credit. Thus, in making the gifts to the children, Sarah totally used up the DSUE from her first husband.  Sarah’s second husband died in 2015 when his Applicable Exclusion Amount was $5,430,000. He had never made any lifetime taxable gifts and passed his entire estate on to Sarah. His estate used none of his Applicable Exclusion Amount and, ***since he was now her last deceased spouse***, his estate transferred $5,430,000 of DSUE to Sarah.  Sarah died in 2016. Her Applicable Exclusion Amount equals her own Basic Exclusion Amount of $5,450,000 plus the $5,430,000 DSUE amount she received from her second deceased husband (now the last deceased husband), for a combined total of $10,880,000.  This example highlights a planning opportunity associated with DSUE and remarriage. Realizing the risk that she could lose the DSUE from her first deceased husband if her second husband predeceased her, Sarah quickly used up the DSUE from her first deceased husband. The end result was that ***Sarah got to make use of the DSUE from both of her deceased husbands and had sufficient transfer tax credits to protect a total of $16,000,000 from taxation.*** |

## Unique Characteristics of Gift and Estate Taxes Summary

This concludes the examination of the unique characteristics of gifts and estates. Below is a summary of the material that has been covered. Review this material carefully and then proceed to the next page.

**Click on each of the following to view the topics covered for each taxation situation.**

|  |
| --- |
| **Characteristics Unique to Gifts** |
| **What Constitutes a Gift**   * Both parties are competent * Unequal exchange * Completed transfer * Irrevocable transfer   **Annual Gift Tax Exclusion**   * For 2015, $14,000 per year to ANY INDIVIDUAL * Indexed for inflation * Husband and wife can split gifts regardless of source of funds * Not cumulative   **Exclusion for Tuition**   * Direct payment for tuition only * For ANY individual and ANY NUMBER of individuals * No limit on amount * Does not affect the Annual Gift Tax Exclusion   **Medical Care Exclusion**   * Direct payment of medical care expenses to the provider of medical care * For ANY individual and ANY NUMBER of individuals * No limit on amount * Not allowed for amounts reimbursed by insurance * Does not affect the annual gift tax Exclusion Amount |
| **Characteristics Unique to Estates** |
| **Gross Estate**   * Includes everything owned by the decedent to the degree he/she had an interest in the property * Includes life insurance owned by the deceased * Includes life insurance and certain other interests in property transferred within 3 years of death * Incomplete transfers are added back to the estate   **Estate Tax Due Date**   * 9 months after death, unless deferred   **Alternate Valuation Date**   * 6 months after date of death * Can only be elected if it reduces the tax   **Portability**   * Since 2010, portability of the Applicable Exclusion Amount between spouses is possible. Surviving spouses can utilize the DSUE Amount of their ***last*** deceased spouse. |

## State Transfer Taxes

Thus far, we have only discussed federal taxes. Depending upon the state in which you reside, state transfer taxes may also impact the tax cost of transfers. Only a handful of states have a gift tax, but all states have some form of death tax. These state death taxes were/are generally in one of the forms listed below.

Note that while the federal Applicable Exclusion Amount is currently high enough that federal transfer taxes will not be an issue for most Americans, the same is not necessarily true regarding state transfer taxes. The excluded amount for state taxes may be much lower, shifting the focus of strategies to minimize taxes upon death from federal taxes to state taxes.

**Click each type of death tax to learn more.**

|  |
| --- |
| **Estate Tax** |
| The estate tax functions similar to the federal estate tax, and is assessed on the value of the estate. |
| **Inheritance Tax** |
| An inheritance tax is the oldest form of death tax, although most states no longer levy it. It is typically levied at a graduated rate based on the amount of the bequest and the relationship to the deceased of the person receiving the bequest. In all states, bequests to spouses are exempt from the inheritance tax. Some states even exempt children and close relatives. In general, the closer the relationship was with the deceased, the less the tax. |

## Review Exercise

Let's review some of the concepts we have covered so far. **Answer the following questions as true or false:**

1. **In 2016, a married couple who are both U.S. citizens can make a joint gift of $28,000 each year that qualifies for the annual gift tax exclusion only if each of them contributes half from their separate funds:**

* True

**Incorrect.** Both spouses can consent to split gifts regardless of the source of funds.

* **False**

**Correct.** It is not necessary for spouses to use separate funds when splitting a gift.

1. **There is no limit on the number of $14,000 annual exclusion gifts that can be made by an individual in 2016, as long as each $14,000 gift in each year is to a different person:**

* **True**

**Correct.** There is no limit to the number of donees who may receive an annual exclusion gift.

* False

**Incorrect.** There is no limit to the number of donees who may receive an annual exclusion gift.

1. **Life insurance owned by the deceased is included in the gross taxable estate only to the extent of its cash surrender value just prior to death:**

* True

**Incorrec**t. Life insurance owned by the deceased is generally included in the gross taxable estate at its full face value, which is the amount paid out upon death.

* **False**

**Correct**. Life insurance owned by the deceased is generally included in the gross taxable estate at its full face value, which is the amount paid out upon death.

1. **If a married couple wishes to directly pay their son's $28,000 annual college tuition in 2016, any additional gifts to their son would be taxable:**

* True

**Incorrect.** The exclusion for tuition is *in addition* to the annual gift tax exclusion. They can still make an annual exclusion gift to their son.

* **False**

**Correct**. The exclusion for tuition is *in addition* to the annual gift tax exclusion. They can still make an annual exclusion gift to their son.

1. **The alternate valuation date is 9 months after death:**

* True

**Incorrect**. The estate tax return is due 9 months after death, but the alternate valuation date is 6 months after death.

* **False**

**Correct**. The estate tax return is due 9 months after death, but the alternate valuation date is 6 months after death.

1. **With portability, a surviving spouse’s Applicable Exclusion Amount equals their Basic Exclusion Amount plus the:**

* **DSUE**

**Correct.** They get to add the Deceased Spousal Unused Exclusion Amount.

* **DSSU**

**Incorrect.** Try again.

* **DESU**

**Incorrect.** Try again.

* **DUSE**

**Incorrect.** Try again.

## Generation-Skipping Transfer Taxes

The final aspect of the transfer tax system to be examined is the Generation-Skipping Transfer Tax (GST Tax or GSTT). This tax helps ensure that every generation gets taxed. It is IN ADDITION TO any gift or estate taxes that may be applicable to a transfer. Therefore, situations that require payment of both a gift/estate transfer tax AND a GST tax are generally to be avoided, as they may result in a combined tax that is close to the value of the transfer.

GST taxation is an area of taxation that is very complex, and usually involves a specialist when it applies. For most professionals, the primary skills needed are:

* The ability to identify skip persons to whom the tax applies.
* The ability to identify events that trigger the tax.

This course will restrict itself to those two skills.

## Identifying Skip Persons

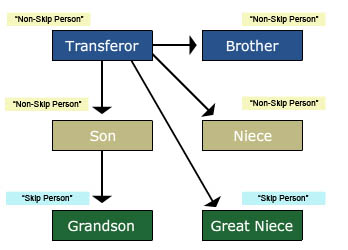
The GST tax applies to transfers of property to individuals who are two or more generations below the person making or triggering the transfer (known as the **"transferor"**). Generally, the transferor is someone who is making a lifetime gift or a deceased person who is transferring or triggering a transfer at his or her death.

Individuals two or more generations below the transferor are known as **"skip persons,"** because a transfer to them would "skip" a generation to get to them. Everyone else would be a **"non-skip person."**

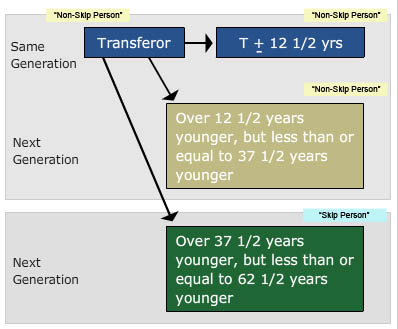
To identify an applicable situation, it is necessary to identify skip persons. Study the chart below carefully. Each arrow represents a possible transfer from the transferor.

**Position the mouse over each of the persons below to identify if the person is a non-skip person or a skip person.**

If **related** to the transferor, a skip person is someone two or more generations below the transferor. For example:



If ***not related***, they are in the same generation if within 12½ years of age. Each successive generation is defined in spans of 25 years. For the illustration below, "T" refers to the Transferor's age:



## Predeceased Parents

When making transfers to lineal descendants, what happens if the parent of a skip person dies before the transfer? Put simply, the successive generations move up one step to fill the void.

|  |  |
| --- | --- |
| Here is the situation before the death: | Here is the situation after the child's death: |
| **predeceased_a_v01** | **predeceased_b_v01** |

|  |  |
| --- | --- |
| **What happens if there are no surviving lineal descendants?**  In that case, this same adjustment to skip persons can be made for any of the descendants of the transferor's parents or the transferor's spouse's parents. **But this only applies when the transferor has no lineal descendants of his/her own.**   |  | | --- | | **Example: John’s Story** John has no lineal descendants. His brother, who died last year, was survived by one child and two grandchildren. If John were to make transfers to his deceased brother's grandchildren, they would no longer be considered skip persons. | |

## Identifying Triggering Events

Three events can trigger the GST tax. **Click each type of event to learn more.**

|  |
| --- |
| **Direct Skip** |
| This is a transfer from the transferor directly to a skip person. It can be a lifetime gift or a transfer from the transferor's estate upon death. |
| **Taxable Termination** |
| This is not a transfer directly from the transferor. Rather, it is a trust or other arrangement in which the present interest of non-skip beneficiaries terminates and only skip beneficiaries remain.   |  | | --- | | **Mr. Smith’s Story**  The trust states that when Mr. Smith dies, the current beneficiary of the trust will be his grandchild (skipping over his child who is still alive). | |
| **Taxable Distribution** |
| When a distribution is made out of a trust to a skip person, this is considered a taxable distribution for GST purposes.   |  | | --- | | **Mrs. Worth’s Story**  Mrs. Worth creates a trust where the trustee can choose to use funds (income or principal) for Mrs. Worth's daughter or granddaughter. As long as no transfers are made from the trust to the granddaughter, GST is not an issue. But it is deemed a taxable distribution if the trustee ever makes distributions for the granddaughter. | |

## The GST Tax Rate and Exemption

The GST tax rate is a ***flat tax*** that is equal to the highest rate on the Unified Transfer Tax Rate Schedule, which is **40%** under current law.

As with gift and estate taxes, not all transfers to skip persons are taxed. The following two rules constitute transfers that can be made without having to pay a GST tax:

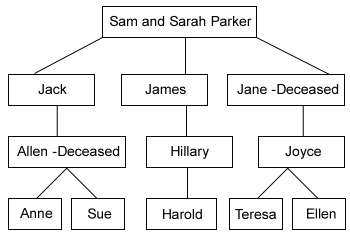
|  |
| --- |
| * All transfers that are excluded from gift taxation are also excluded from GST taxation. This includes annual exclusion gifts, direct payment of tuition, and direct payment of health care. * There is a cumulative exemption amount for GST tax purposes. That cumulative exemption amount is always equal to the Applicable Exclusion Amount for estates. Only cumulative taxable transfers to skip persons that exceed that exemption amount are subject to payment of the GST tax. For 2016, the GST Exemption is $5,450,000 (adjusted each year for inflation). |

Note, however, that while a deceased spouse’s estate can pass on the deceased spousal unused exclusion amount (DSUE amount) to the surviving spouse, this ***portability is NOT AVAILABLE for the GST Tax Exemption***.

Given that the GST tax is ***in addition to any gift or estate tax that may be due***, the GST tax essentially results in a doubling of the transfer tax liability. This is generally prohibitive! The end result is that the GST tax is generally to be avoided and all transfers subject to the tax should be limited to those that can be protected from having to pay the tax by use of the GST Tax Exemption.

## Review Exercise

The following chart shows the family tree of Sam and Sarah Parker. Their son, Jack, plans to make a number of transfers.





1. From the list below, select the skip person(s) to Jack:

 James

Anne

 Sue

 Hillary

 Harold

|  |  |
| --- | --- |
| Answer Key | |
| 5 | **Correct. James is in the same generation as Jack, Hillary is only one generation below Jack, and Anne and Sue are no longer skip persons due to the predeceased parent rule.** |
| Others | Incorrect. Try again. [Hint: there is only one skip person listed.] |

1. From the list below, select the skip person(s) to Jack:

 Joyce

Theresa

 Ellen

 Hillary

 Harold

|  |  |
| --- | --- |
| Answer Key | |
| 2,3,5 | **Correct. The predeceased parent rule does not apply to collateral heirs so long as Jack has lineal descendants, therefore Theresa and Ellen are skip persons to Jack, as is Harold.** |
| Others | Incorrect. Try again. [Hint: remember that the predeceased parent rule does not apply unless there are no lineal descendants; therefore there are three skip persons listed. |

1. From the list below, select the skip person(s) to Jack:

 Anne

Sue

 Harold

 Teresa

 Ellen

|  |  |
| --- | --- |
| Answer Key | |
| 3,4,5 | **Correct. Anne and Sue are not skip persons to Jack due to the predeceased parent rule; the rest are skip persons to Jack.** |
| Others | Incorrect. Try Again. [Hint: remember that the deceased parent rule only applies to collateral heirs if there are no lineal descendants. In this case, there ARE lineal descendants.] |

1. In addition, Jack plans to make distributions to the following non-related persons. If Jack is 50 years old, select all the persons who are skip persons to Jack.

 Steve (age 55)

Irene (age 30)

 William (age 15)

 Wendy (age 10)

|  |  |
| --- | --- |
| Answer Key | |
| 4 | **Correct. Nonrelated persons are skip-persons ONLY if their age is at least 27 ½ years below the age of the transferor.** |
| Others | Incorrect. [Remember that non-related skip persons are those persons at least 37 ½ years younger than the donor.] |



## Income Tax Issues Related to Gifts and Estates

While most of this course deals with transfer tax issues independent of income taxation, there are some income tax issues related to the transfer of assets that are important considerations in the estate planning process. Obviously, income taxation can be an exhaustive subject unto itself. For purposes of this course, we will simply note three income tax issues that are of concern to estate planners. These are listed below.

**Click each issue to learn more:**

|  |
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| **Charitable Deductions** |
| We have already discussed the fact that gifts to charities do not generate a gift tax. With some limitations, gifts to qualified charities are also deductible items for income tax purposes. The following pages will provide more detail as to how this works. |
| **Step-Up in Basis at Death** |
| Generally speaking, assets owned at death receive a step-up in tax basis to their current market value (either at date of death or at the alternate valuation date 6 months after death). |
| **Income in Respect of a Decedent** |
| Also known as IRD or Code Section 691 income, this is income to which the decedent was entitled as of date of death, but which was not properly includible in the decedent's income tax return (Form 1040) because the decedent had not collected it. The following pages will describe the types of items that are considered IRD. |

## Charitable Income Tax Deductions

To obtain a charitable deduction on the federal income tax return, a contribution must be made to, or for the use of, certain qualified organizations. The IRS publishes a list of approved charities in Publication 78.

Depending upon the type of charity and the type of property being contributed, there is a limit to how much can be deducted in any given year. This limit is stated as a percent of the adjusted gross income of the donor (excluding any net operating loss carryback). If a transfer to a charity exceeds the amount that can be deducted in a given year, the balance of the deduction can be carried forward for 5 years.

Types of Charities

Only public charities qualify as 50% charities, indicating that up to 50% of an individual taxpayer’s adjusted gross income can be deducted for the charitable transfer. All other charities qualify for lesser amounts in a given year. Note, however, that generally if appreciated property is transferred to a public charity and the deduction is for its fair market value, the limit becomes 30%.

**Click on each of the following to view an overview of the various types of charities.**

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| **Public Charities** |
| Public charities are often referred to as 50% limit organizations because deductions on donations to them are generally limited to 50% of the donor's adjusted gross income (excluding any net operating loss carry back). They include:   * Churches * Synagogues * Colleges * Universities * Hospitals * U.S. Government * State Government * Private Operating Foundations * Private Distributing Foundations * Private Foundations that Maintain a Common Fund * Publicly supported corporations, trusts, or community chests, funds, or organizations that exist for charitable, religious, educational, scientific, or literary purposes, or to prevent cruelty to children or animals, or to foster certain amateur sports. |

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| **Private Operating Foundations**  **Private Operating Foundations** use most of their income to provide charitable services or to run their own charitable programs. They make little in the way of charitable grants. |

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| **Private Distributing Foundations**  **Private Distributing Foundations** are "non operating foundations," meaning that they themselves do not provide charitable services. However, they are considered public charities because they distribute 100% of contributions within 2½ months following the year they receive the contributions. |

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| **Private Foundations that Maintain a Common Fund**  **Private Foundations that Maintain a Common Fund** are private foundations that are operated for the benefit of public charities. The funds of contributors are pooled together, with all income distributed to public charities within 2½ months following the tax year in which it was realized. They must also distribute the principal no later than 1 year after the donor's death or the death of the surviving spouse, if the spouse can name the recipient. |

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| **Private and Semi-Public Charities** |
| Private charities include Non-Operating Foundations that do not meet the distribution requirements to be treated as a public charity. Semi-public charities include Veterans Organizations, Fraternal Societies, and Nonprofit Cemeteries.  These are subject to special tax rules that lower the percent of adjusted gross income that can be deducted on an individual’s federal income tax return for contributions in a given year. |

## Step-up in Basis at Death

The second aspect of income taxes to be examined is the step-up in basis that occurs at death. Under current law, when a person dies, most assets owned in the estate (with some exceptions such as certain interests in foreign entities and income in respect of a decedent) receive a "step-up" in basis for federal income tax purposes. The result is that instead of using the decedent's purchase price for computing the tax basis of an asset, its tax basis is re-established as of the date of death (or the alternate valuation date 6 months later, if elected by the executor

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| **"Stepped-Up" Basis Example**  An individual purchased a security for $50,000. Years later, when the individual dies, the fair market value of the security is $100,000.  If the asset is liquidated by the executor or distributed to an heir, the basis used for calculating capital gains will be $100,000, not $50,000. |

This has been an important feature of estate planning because it is often possible to avoid paying capital gains taxes simply by holding the asset until death, when the step-up takes place. Since there was no limit on the amount of step-up available for deaths, substantial income taxes can be avoided in this manner.

## Income in Respect of a Decedent

***Income in Respect of a Decedent*** (also known as IRD or Code Section 691 income) is income to which the decedent was entitled as of the date of death, but which was not properly includable in the decedent's individual income tax return (Form 1040) under the decedent's method of accounting (typically cash basis or possibly accrual). Any income in respect of a decedent, whether it is received by the estate of the decedent, or payable to a named beneficiary, is likely to be included as an asset of the estate of the decedent. Examples of IRD items for a cash basis taxpayer are listed below.

* Cash dividend received on stock if the record date of the dividend precedes the decedent’s date of death.
* Salary and bonuses earned by the decedent, but not by the date of death.
* Deferred salary payments that are payable after death.
* Deferred compensation such as sales incentives or profit sharing to which the decedent was entitled, which is paid to the estate or beneficiary after death.
* Self-employed business accounts receivable payments received after the date of death.
* Unpaid royalties or rents attributable to pre-death time periods
* Interest accrued prior to date of death, but paid after the date of death.

## Conclusion

This concludes the material for this subject. As you can see from the list at right, the scope of the material we covered in this course is extensive. Therefore, at this time you may wish to return to any sections in which you feel the need for further study.

Note that this subject matter is not static; changes take place each year. Therefore, to remain current, it is important that you find resources to periodically stay abreast of changes, as these may impact the planning strategies that may be utilized.

Much of this can be picked up in the general news media, but you may be interested in subscribing to the IRS newsletter entitled "IRS e-News for Tax Professionals," which circulates about twice a month. While it covers news in all areas of taxation, it begins with a brief list of topics discussed (usually less than 10), allowing you in less than a minute to discern if there are any topics of interest to you. Towards the end of each year, as gift and estate tax numbers adjust for the next year, this newsletter will also alert you to those changes.

You may subscribe by clicking going to the IRS home site at: <http://www.irs.gov>.

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| **Course Review**  This course covered the following taxation topics. Before proceeding to the exam, satisfy yourself that you are familiar with each topic:  **Gift and Estate Tax Similarities**   * Unified Transfer Tax Rates * Applicable Credit Amount * Applicable Exclusion Amount * The Unlimited Marital Deduction * Charitable Deductions   **Gift Tax Differences**   * What Constitutes a Gift * Annual Gift Tax Exclusion * Exclusion for Tuition * Medical Care Exclusion   **Estate Tax Differences**   * What is Included in the Gross Estate * Estate Tax Due Date and Alternative Valuation Date * Joint Property * Estate Valuation * Portability Between Spouses Beginning in 2011   **Generation Skipping Taxes**   * How to Identify Skip Persons * The Predeceased Parent Rule * Triggering Events * The GST Tax Rate and Exemption   **Income Taxes Related to Gifts and Estates**   * Charitable Deductions * Step-Up in Basis at Death * Income in Respect of a Decedent |